

Introduction

The MPM maintained their economic outlook virtually unchanged at the mid-term review today. Nevertheless, the policy statement suggests stronger confidence in our economic recovery, largely because of diminishing factors of downside risks overseas.

Let me discuss the major points of today's press conference by Governor Kuroda.

Outlook of economy and prices

Members of the policy board now expect that our economy will grow at 1.4% in FY2014 and 1.5% in FY2015 measured as median of their outlook. It would be hard to identify some marginal differences from their outlook in last October.

As Governor Kuroda importantly insisted, the current economic outlook by the BOJ seems to converge with those by majority of private sector economists in Japan. In contrast, however, there remains a divergence in terms of outlook of inflation.

According to the outlook by the MPM, their members expect 1.3% inflation in FY2014 and 1.9% in FY2015 respectively, again as median of the outlook. The BOJ effectively shows confidence in the achievement of their 2% inflation target in FY2015. As the readers are aware, there remains persistent skepticism about it among private sector economists.

Governor Kuroda reiterated his view that the understanding of formation of inflation expectation would be a possible source of such divergence. The BOJ now believes in "adaptive formation of expectation". Namely, our economic agents will expect higher inflation after observing positive developments so far, and it could become self-fulfilling. Readers may recall this is the "second-round effect" of inflation that a central bank would like to avoid in normal times...

Meanwhile, majority of private sector economists are not persuaded to believe in such mechanism. In terms of the model of Philips Curve, they would not accept the view that the curve itself could move upward in this short period of time. Therefore they would expect milder rate of inflation in FY2015, even if they agree that higher rate of economic growth could remove deflationary gap in terms of GDP in the end.

Difference of the views could be clearer in coming months. Today's policy statement suggests that even the BOJ expects some pause in upward trend in inflation for the time being. Apparently it is because of the diminishing effects of currency depreciation as well as import prices hike. Nevertheless, according to Governor Kuroda's comment, the BOJ thinks that tightening aggregate demand condition could accelerate our inflation again toward the end of FY 2014. Taking account of these elements, the BOJ seems to expect a step-wise development of inflation in FY2014.

In any case, around the time of such pause, we could observe stronger skepticism which could result in a driver for request for additional stimulus. Moreover, Governor Kuroda explained that the BOJ intended to refer to six months by using the phrase of "for the time being". These are the reasons why domestic market participants maintain the view that 1) next regular review of the BOJ's outlook in April, or 2) early summer when the economic indicators covering the impacts of consumption tax hike are available, would still be some pivotal time for policy discussion.

Management of QQE (continued)

Readers would like to remember that, at the press conference in December, Governor Kuroda clearly explained that QQE could be maintained in an open-ended manner until the inflation target is stably achieved. His comment was intended to remove the uncertainties about the policy strategy after FY2015. In fact, there was some misunderstanding in the markets that the BOJ could withdraw from QQE in FY2015 regardless of the inflation performance.

Interestingly, however, Governor Kuroda insisted as a reply to a press reporter today that their declaration of achievement of 2% inflation in two years time in April 2013 has also underlying impacts on the improvements of inflation so far.

From the view points of formation of inflation expectation, these two lines of ideas would imply that the BOJ relied on a forward-looking inflation expectation in earlier period of QQE, but will rely on "adaptive" formation of inflation expectation in coming months (as discussed in the previous section).

While it might appear to be a type of time inconsistency, it would not be fair to criticize it outright at least for the time being. It is because nobody has comprehensive understanding of mechanisms of inflation expectation, and the BOJ should conduct monetary policy under high uncertainties about this crucial part of policy transmission.

Nevertheless, most important challenge for this kind of policy dynamics would be a "diminishing return" of intended effects on inflation expectation. At the same time, if the BOJ overemphasize at this stage that they are ready to take any actions to achieve the inflation target, it could rather appear to the market that the BOJ might have some concerns.

All in all, communication strategy by the BOJ will remain very important in later phase of QQE but because of the different set of reasons.

Conclusions

It is an year since the BOJ issued a joint policy statement with the government to make utmost collaboration for exiting from decades long deflation. And it is in fact encouraging to observe the substantial improvements of our economic sentiments during this period of time for whatever reasons.

Governor Kuroda might hear in Davos in coming days, however, that we might be running out of time until the international community would not allow us to depend on such extraordinary set of economic policy, unless we could make substantial progress in structural reforms, as my good friends in DC and NY suggested me last week.

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